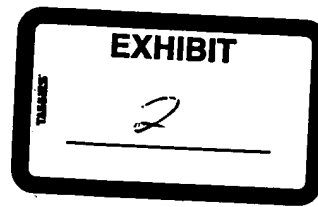


Risk Assessment Training Documentation:



# RISK ASSESSMENT

**December, 1999**

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## **SuperLink RISK ASSESSMENT PROGRAM USER GUIDE**

The project to develop this product began in 1998 and was driven by several department needs or desires. First as we began moving to a central point of contact ("CPC") approach to supervision, it became more critical that each CPC be privy to current supervisory and risk information on all facets of a banking organization's operations, not just those related to safety and soundness. Second, the surveillance efforts in the non-safety and soundness sections of the department were limited and the results were not routinely communicated to the safety and soundness CPCs. Third, every section had its own ideas of how to create a "Watch List", and there was no uniformity of opinion on the criteria for placing an institution on or removing it from the Watch Lists. The direction management gave to the work group was to develop a comprehensive surveillance process that was structured to support the CPC approach. Although there was no initial thought of using SuperLink to accomplish the mission, it became clear early in the process that use of such a system afforded many administrative benefits.

What is presented is the first iteration of the Moore Umbrella's (hereinafter, referred to as the department) revised surveillance process. For the most part, safety and soundness examiners will note little difference from what they are currently doing other than a slight increase in data input. Specialty area (CA, ISS, FASS, and CRM) examiners may find that there is additional work to do, but the degree of surprise will depend upon how much of the proposed new surveillance processes have been shared by the respective Banking Supervisors.

In mid-1998, two separate safety and soundness surveillance policies / procedures were adopted, one for institutions larger than \$1 billion ("LCBOs") and one for those less than \$1 billion ("Community"). Since their implementation, the work group has suggested relatively minor changes. In 1999, surveillance programs were proposed for CA, CRM, and the various components of FASS. Because of the Y2K initiative, department management agreed to defer the development and implementation of the ISS surveillance program until 2000. Implementation of the CA, CRM, and FASS surveillance programs is to begin in 1999.

While each of the surveillance programs is unique to the needs of the specific section and is performed on a unique schedule, the guiding philosophy of the current initiative is that problems or issues in the specialty examination areas must be expressed in terms of the six risks (credit, market, operational, liquidity, legal, and reputational) utilized by safety and soundness examiners. This is the point where SuperLink comes into play. The expectation is that examiners, irrespective of section, will complete their surveillance activities and prepare their documents in accordance with the directions from their section's management. However, as you will observe as you read further, each section will need to express their concerns in terms of the type of risk it poses to the institution, the level of the risk, and the expected direction of the risk.

The mechanics of the SuperLink system are such that the risks of each individual area flow up to the safety and soundness CPC in order that one individual can make an assessment of the risk profile for an entire organization. At the same time, managers of the specialty areas can continue to keep track of institutions that pose risks specific to that specialty area. Said another way; a safety and soundness CPC whose institution's Section 20 subsidiary is a problem; will need to decide to what degree the problems in the Section 20 elevate the risk to the overall institution. While the CPC may determine that the size of the Section 20 and the nature of its problems are not significant in the context of the overall organization, the manager of FASS still has the opportunity and responsibility to keep the Section 20 on the FASS radar.

This two-tiered approach (CPC and Section) allow for the maintenance of two levels of what used to be called Watch Lists. However, given the difficulties noted above with the term "Watch List", that term will no longer be used. The current term is "High Risk Institutions" on both

the composite rating basis and for the specific specialty areas. How institutions arrive on the High Risk Institutions Report ("HRI Report") is discussed further on in this document.

One of the features of Lotus Notes that will be utilized in a future release of this program is the notification of individual examiners that a surveillance document for an institution they are responsible for is due to be completed (based upon the frequency established in the individual section surveillance programs) and the subsequent notification of the portfolio manager if it is not completed timely. Lotus Notes also aids in the review/approval process and allowing for any number of management reports.

## PROCEDURES TO COMPLETE A SuperLink RISK ASSESSMENT

### Overview of System

The new Risk Assessment Database in SuperLink provides a comprehensive method for preparing, reviewing and reporting risk assessments. This process is to be used for all risk assessments prepared for surveillance regardless of section. The risk assessment should highlight both the strengths and vulnerabilities of an institution as well as providing a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution. Therefore the entire SuperLink Risk Assessment program is driven by the following six risk factors as defined in SR 97-24(SUP):

- **Credit risk**, which arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- **Market risk**, which is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- **Liquidity risk**, which is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").
- **Operational risk**, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- **Legal risk**, which arises from the potential that unenforceable contracts, lawsuits, or adverse judgements can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- **Reputational risk**, which is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

The SuperLink risk assessment matrix is used to identify significant activities, the type and level of inherent risk in these activities, and the adequacy of risk management over these activities as well as to determine composite risk assessments for each of these activities and the overall institution.

Once the significant activities are identified, a composite risk "rating" of high, medium or low as well as a trend "rating" of increasing, decreasing, stable must be assigned. The composite risk rating assigned should be based on the following guidelines:

- A **high composite risk** generally would be assigned to an activity where the risk management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition, even in some cases where the systems are considered strong. For an activity with moderate inherent risk, a risk management system that has significant weaknesses could result in a high composite risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.
- A **moderate composite risk** generally would be assigned to an activity with moderate inherent risk where the risk management systems appropriately mitigate the risk. For an activity with a low inherent risk, significant weaknesses in the risk management system may

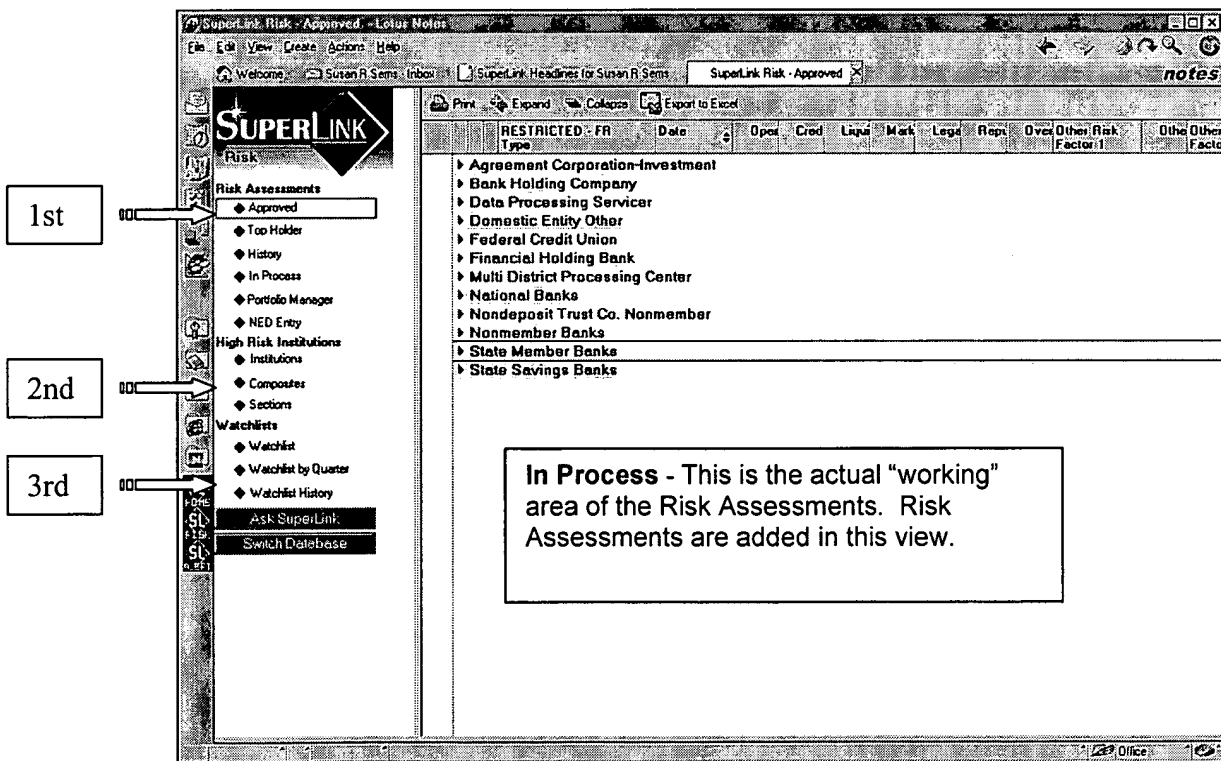
result in a moderate composite risk assessment. On the other hand, a strong risk management system may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.

- A **low composite risk** generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk where internal controls and risk management systems are strong and effectively mitigate much of the risk.

## Risk Assessment

The Risk Assessment database provides three types of views. The first (1<sup>st</sup>) view is the Risk Assessments. Within this view are the following six sub-views:

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|--------------------------|---|
| <u>Approved</u>          | this view will show each risk assessment that has been approved.  |
| <u>History</u>           | this view will show a complete history of all risk assessments.   |
| <u>Top Holder</u>        | this view will show bank holding companies and their subsidiaries   |
| <u>In Process*</u>       | this view will show each risk assessment that is in process but not yet approved by the supervisor. This is the actual "working" area of the Risk Assessments. Risk Assessments are added in this view. |
| <u>Portfolio Manager</u> | this view will show each risk assessment that is approved for each institution assigned to a portfolio manager.   |
| <u>NED Entry</u>         | this view will show NED forms for risk assessments that have been approved  |



The second (2<sup>nd</sup>) view is the High Risk Institutions view. This view contains the Overall Risk Comments from the most recent SuperLink Risk Assessment, as well as summary and update comments from the Banking Supervisors. It is broken into the following three sub views.

<u>Institutions</u>	all institutions assigned a High Risk rating on at least one component on either the composite or sectional risk ratings.
<u>Composite</u>	all institutions assigned a High Risk rating on at least one component on the composite risk ratings and listed by the Supervisor of the institution.
<u>Sections</u>	specialty institutions assigned a High Risk rating on at least one component on the sectional risk ratings and listed by the particular area.

The High Risk Institution view replaces the manual High-Risk Institutions process. When an institution has been assigned **one or more High rating** in **any risk category in any risk assessment**, it is automatically placed on the High Risk Institutions Report (view). Functionality has been added to this process to allow the Portfolio Managers / Supervisors the ability to manually override a risk assessment in order to place an Institution on or take it off the High Risk Institutions Report.

The third (3<sup>rd</sup>) view is the Watchlist view. The watchlist view contains comments from the Banking Supervisors. **Unlike the High Risk Institutions view, the Watchlist view does not contain Overall Composite Risk comments from the SuperLink Risk Assessment.** It is broken into the following three sub-views:

<u>Watchlist</u>	all institutions assigned a High Risk rating on at least one component on the most recent composite or section risk assessment, including summary comments from the Banking Supervisors.
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<u>Watchlist by quarter</u>	all institutions on the watchlist sorted by date of the watchlist comments from the Banking Supervisors
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Watchlist History  
all institutions on the watchlist sorted by institution type. Shows current and past SuperLink Risk Assessments and the corresponding watchlist comments

There are two types of risk assessments that can be prepared for each institution using this database.

